Legislation Makes Major Changes in Acceptable Combinations of Financial Firms

The Gramm-Leach-Bliley Act of 1999 eliminates Depression-era constraints on mergers of banks, securities firms, and insurance companies, making it easier for a single firm to supply a wide array of financial services to consumers and businesses. The legislation also allows most rural banks to join the Federal Home Loan Bank System for access to long-term funds that can be loaned for housing, agriculture, and small business purposes.

President Clinton signed Public Law 106-102, the Gramm-Leach-Bliley Act of 1999 (GLB), into law on November 12, 1999. This legislation reforms the financial industry by allowing banks, securities firms, and insurance companies to merge so that consumers and businesses can purchase all of their financial services from the same company. GLB also addresses other issues of concern to rural lenders, businesses, and consumers, such as access by rural banks to funds from the Federal Home Loan Bank System, moving rural deposits to urban areas, combining commercial firms and banks, and privacy of personal financial information.

Restructuring the financial sector took years of effort by the administration, Congress, financial regulators, consumer groups, and trade organizations representing various sectors of the financial services industry. Several issues almost derailed the legislation even after its basic framework was generally agreed upon. Conflicts arose among the banking, insurance, and securities industries, between regulators, and between small and large banks. Members of Congress with different views disputed issues such as the Community Reinvestment Act and whether to allow banks and industrial corporations to also buy each other. Many small banks and other observers argued that some proposals would concentrate economic power in a few giant, noncompetitive firms.

Combining Banks, Securities Firms, and Insurance Companies

The Gramm-Leach-Bliley Act is best known for allowing banks, securities firms, and insurance companies to buy each other. GLB repealed the provisions of the Glass-Steagall Act of 1933 and amended other legislation that prohibited combinations of banks, securities firms, and insurance companies. The Glass-Steagall Act was a response to the Great Depression of 1929. Many people still feel that these sorts of mergers create large firms that tend to neglect small businesses and consumers who are not wealthy or result in conflicts of interest that are harmful to consumers.

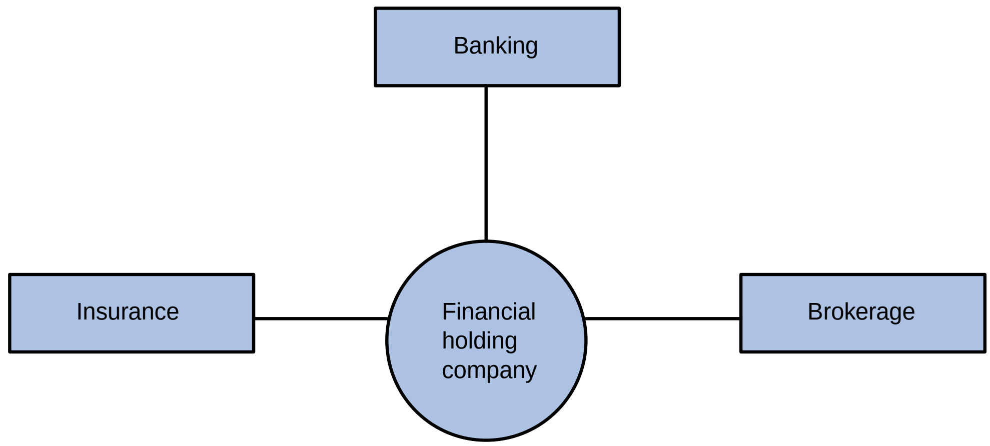
Letting commercial banks affiliate with other financial firms enables banking organizations to compete effectively in a financial world that continues to evolve rapidly. Large banks compete in world markets against foreign institutions that face fewer restrictions on bank activities. Rural banks contend with the Farm Credit System to make agricultural loans. Small banks compete against large banks for certain services. For example, large banks market credit cards nationally through the mail, and some are starting to apply similar methods in financing small businesses. Banks of all sizes also compete with other financial institutions and nonfinancial firms to provide financial products. Commercial lending used to be dominated by commercial banks, but today large corporations routinely obtain financing directly and at lower cost from the capital markets by selling commercial paper (unsecured short-term notes). Manufacturers of automobiles and farm equipment have their own finance subsidiaries. Consumers invest in money market funds, mutual funds, and brokerage accounts in place of traditional bank checking and savings accounts.

Citigroup was created prior to GLB by the 1998 merger of Citicorp and Travelers Group, but the insurance portion of the company would eventually have had to be sold if bank reform legislation had not passed. GLB will likely lead to other mergers in the next several years that combine giant firms in the banking, brokerage, and insurance industries (fig. 1). But rural community banks will not necessarily lose many customers to these conglomerates. People often prefer dealing with small, locally owned businesses, provided this does not result in lower quality service and products or significantly higher prices. GLB also permits banks, including community banks, to offer new products and services to their customers. For example, community banks can form subsidiaries that enter into joint ventures with other banks and thrifts to sell financial services, rather than trying to go it alone

Figure 1

New financial combinations allowed

New legislation allows for one company to provide banking, insurance, and brokerage services



Source: USDA, Economic Research Service.

through their own holding company affiliates. This should help small rural banks to profitably provide their customers with a wide range of financial products, rather than having to recommend other firms for some services. Technology allows small banks to provide advanced services such as Internet banking, since this technology can be acquired at a reasonable cost from third-party providers rather than developed in-house.

The Bank Holding Company Act of 1956 prevented combinations of financial and commercial firms, positing that banks may favor businesses in which they have made equity investments. Banks might even continue to lend large sums to dying firms to maintain the value of their equity investments. This has been observed in countries such as Indonesia, Korea, and Japan. Hence, GLB maintains the prohibition against combining financial and commercial firms, though this issue may surface in coming years.

GLB also addresses the fact that companies that control a single savings and loan institution (unitary thrift holding companies) are able to mix banking and commerce. Reports that Wal-Mart was planning to acquire a unitary thrift galvanized opposition from the banking industry and others. GLB declares that no new unitary thrifts can be created and that no more commercial firms can purchase existing unitary thrifts. While rural banks avoid some potential new competition, rural borrowers lose the possible benefits of that same competition.

Access to Federal Home Loan Bank Advances

The most important feature of GLB for rural lenders and borrowers may be Title 6, the Federal Home Loan Bank System (FHLBS) Modernization Act of 1999. This act makes it easier for most rural banks to join the FHLBS and access funds for lending to farmers and other rural businesses.

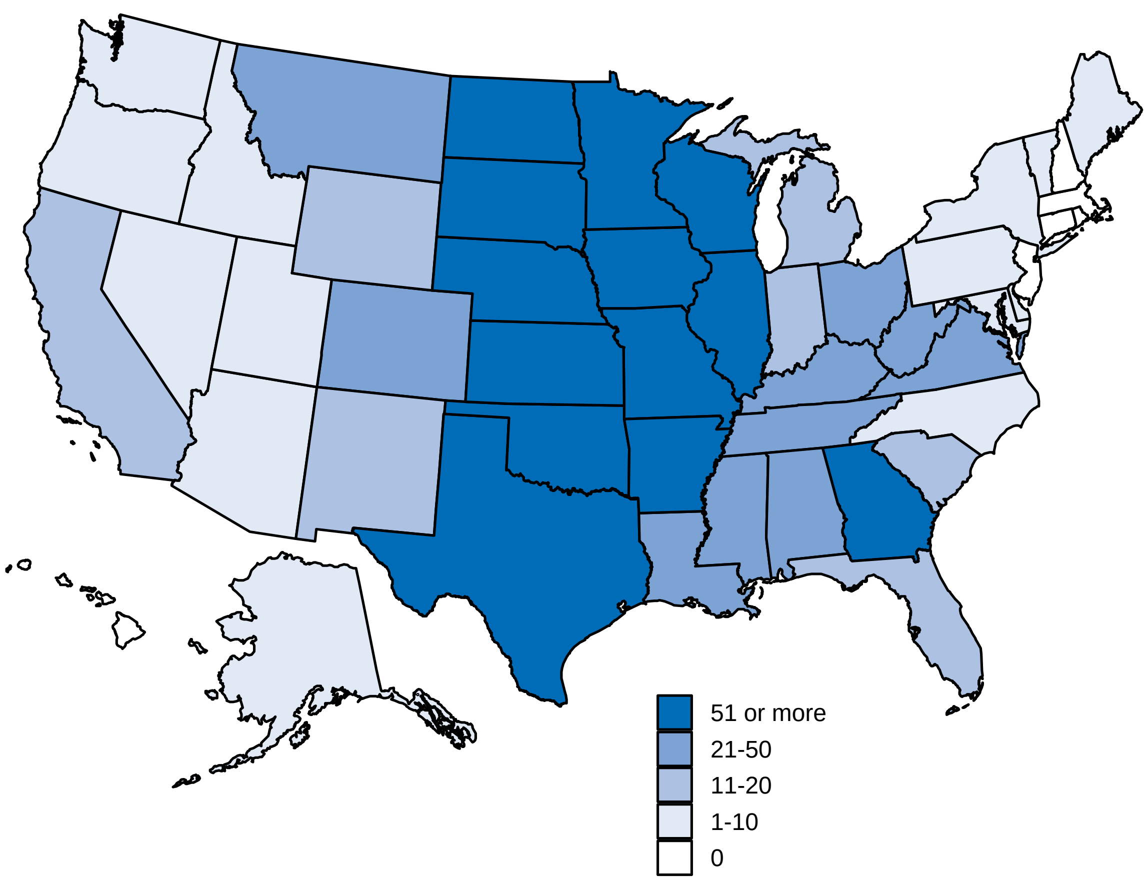
The FHLBS originally served savings and loans (S&L's) and other thrift financial institutions, which primarily made mortgage loans and were required to join the FHLBS. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 permitted commercial banks to join, provided they met requirements concerning the extent of their mortgage lending business. The FHLBS District banks make loans (called advances) to their members, giving banks and S&L's funds to make additional mortgage loans. Advances are a stable, national, longer term source of funds, versus local deposits that can be withdrawn at any time. This helps to mitigate the maturity mismatch between short-term deposits and long-term mortgages, which crippled many financial institutions in the 1980's when interest rates paid by banks and S&L's to their depositors exceeded rates charged on mortgages made a few years earlier.

The new legislation further extends the Federal Home Loan Bank System so that banks with less than $500 million in assets can use small business and agricultural loans in addition to mortgage loans as collateral for FHLBS advances. Many small banks are in rural areas and have achieved higher loan-to-deposit ratios in recent years. Whether this is due to slow deposit growth or rapid loan growth, some banks may welcome and need an alternative to deposits so that they can fund additional loans. At the end of 1998, 4,925 of the 8,757 insured commercial banks were already FHLBS members. Of the remaining nonmember banks, the 2,165 rural banks with assets under $500 million, many located in the farm States in the center of the country, are now eligible to join FHLBS unless they are disqualified on safety and soundness grounds (fig. 2). These banks are not all newly eligible—some chose not to join even though they met previous mortgage loan requirements. But the expanded collateral makes it likely that many nonmembers will rethink their decisions.

Figure 2

Rural banks that were not members of the Federal Home Loan Bank System at the end of 1998

Many more rural banks throughout the country can join the Federal Home Loan Bank System



Source: Calculated by ERS using data from the Federal Housing Finance Board and the Federal Reserve Bank of Chicago.

While expanded access to the FHLBS should benefit rural banks and their loan customers, depositors at some rural banks may see moderately lower interest rates on their bank deposits. Banks that had secured additional loanable funds by increasing interest rates paid on consumer deposits might now obtain FHLBS advances instead.

Rural Deposits, Loans, and the Community Reinvestment Act

Some rural advocates argue that large urban-based banks use their rural branches mainly as a source of low-cost deposits that are loaned more profitably elsewhere. While the extent of such behavior remains an open question, GLB addresses the issue from two directions. Bank holding companies are prohibited from using any of their branch offices to gather deposits with no real intention to make loans in those communities. GLB applies the Community Reinvestment Act (CRA)—depository institutions (banks and thrifts) must serve all segments of their communities—to depository institutions owned by the new financial holding companies created under the legislation.

While CRA is often associated with redlining in low-income areas of large cities, 1995 revisions enhance its potential importance for rural communities. Large banks must provide annual data on loans to small businesses and farms for each market in which they make loans. Evaluating whether a financial institution made “enough” loans in a particular market is quite difficult, since specific firms may specialize in distinct segments of the credit market and no data are available to describe the total amount of creditworthy demand for loans. Still, the reporting requirement will likely ensure that large banks do not simply ignore rural borrowers in communities where they have bank offices.

Small banks argue that community banks by definition serve all segments of their communities and consider compliance with CRA a costly drain on their resources. Rather than justifying their lending performance, bank officers argue they could better spend their time by making more loans. One initial version of the GLB would have exempted rural banks with less than $100 million in assets from CRA. In one of the critical compromises that allowed passage of GLB, the final legislation does not exempt any banks, but lengthens the period between CRA examinations to 5 years for small banks with outstanding ratings and to 4 years for those with satisfactory ratings. Further, details of CRA-related agreements between banks and community activists will be publicized and the Federal Reserve must perform a study to analyze the effects of CRA.

Regulating Financial Institutions

Officials at the Federal Reserve Board (Fed) believe that Federal deposit insurance funds would be further safeguarded if banks wishing to enter insurance and securities industries would provide their newly authorized financial services through nonbank affiliates of their parent bank holding companies (BHC’s). The Department of Treasury and the FDIC argued that the same degree of safety could be achieved if banks provide these services through subsidiaries of the banks themselves. These agencies also noted that a subsidiary supports the parent bank, while pushing activities to a holding company draws capital out of the bank. This point may seem technical, but serious problems with the Farm Credit System and numerous failures of many rural banks and thrifts during the 1980’s and early 1990’s demonstrate that rural communities cannot disregard proper regulation of financial institutions.

A BHC owns one or more banks and possibly other firms that do things such as processing checks or providing discount brokerage. For services offered through nonbank affiliates, the Fed would maintain an important role since it supervises BHC’s. The agencies compromised by allowing banks to provide most activities through either holding company affiliates or bank subsidiaries. But only holding company affiliates may underwrite insurance (both can sell insurance) or make speculative equity investments (merchant banking investments).

Insurance Sales

Some rural jobs may be lost since large banks will no longer have to base certain insurance operations in small towns. As interpreted by the Supreme Court and Federal regulators, Section 92 of the National Bank Act allows national banks with branch offices in towns of fewer than 5,000 inhabitants to sell insurance by acting as agents of licensed insurance companies. Policies could be sold to people living elsewhere, but the bank's insurance agents really had to work from the local office. Powers granted to national banks often apply to State-chartered banks as well, because in many cases States pass laws permitting their State-chartered banks to match the services of national banks. Banks that qualify for the small-town exemption may continue to use it. But GLB allows banks to sell insurance from any location, either in an affiliate of its holding company or in a subsidiary of the bank. Thus, some banks may transfer their existing insurance operations to large cities.

Privacy Concerns

Increasingly frequent media reports about hackers breaking into computer systems to steal lists of credit card numbers, and detectives obtaining checking account information by pretending to be someone else, have created serious concerns about the privacy of financial information. On top of this, legitimate companies sell information gleaned from customer accounts. A backlash against this activity led to a privacy provision in GLB. But this issue is not completely one-sided. Many of us hate getting junk mail or unsolicited phone calls, unless the product or service being sold is something that we want. And the concept of a financial holding company is predicated on being able to market and sell a variety of financial services to consumers and businesses.

Debate over this area revolved around two points of contention: (1) the distinction between selling information to non-affiliated firms versus providing it to affiliates or subsidiaries of the bank; and (2) whether the default approach would be for information to be distributed to other parts of the firm and sold to other corporations only if consumers requested that to occur (opt-in), or to allow a bank to market customer information elsewhere unless the customer says not to do so (opt-out). The final GLB Act compromise uses an opt-out approach for sales to other companies but permits information transfers to other parts of the organization.

A New Financial World?

It remains to be seen whether financial conglomerates created under the reform legislation will succeed. The concept of a financial supermarket has been around for many years, but previous attempts by firms such as Sears to actually operate them were not considered very successful. Financial supermarkets stress cross-selling of other financial products. For example, bank tellers and inserts in monthly statements inform us about computer banking, home equity loans, debit cards, and brokerage accounts. While most people purchase their main computer software applications as an office suite, it is too soon to say whether that will prove true for financial services.

Technological advances may both help and hinder these efforts. Technology can support efforts at cross-selling a variety of banking, insurance, and investment products. When someone calls or visits a bank branch, or even uses an ATM, the bank will quickly call up information about the customer's current accounts with the bank, and suggest additional services that similar customers have purchased. If bank customers are convinced that these services are priced competitively, provided in a safe and efficient manner, and that they can save time by doing all of their financial shopping in a single location, financial holding companies may succeed.

But technology also empowers consumers to search for price information from firms throughout the country and to acquire financial and other products without leaving home. Internet financial web sites present an alternative model to the financial supermarket. By clicking on various links, consumers can select an online brokerage firm, request quotes for mortgage loans and life insurance, and perform many banking functions through the web site of their banks. Financial giants such as Citigroup might be among the companies offering services over the Internet, but specialized banks, insurance companies, and brokerage firms can also compete for specific services. *[Daniel Milkove, 202-694-5357, dmilkove@ers.usda.gov]*